Subsequent Events in Gift and Estate Tax Valuations

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Subsequent events are sometimes considered in the development of a business valuation. This statement is true for business valuations that are developed retrospectively. Events which take place after the valuation date may require special consideration based on analysis-specific circumstances. This discussion provides guidance to understand how and when subsequent events may—or may not—be considered in a business valuation prepared for federal gift and estate tax planning, compliance, or litigation purposes.

Introduction

This discussion outlines the considerations of subsequent events in the valuation of businesses, business interests, and intangible assets for federal gift and estate tax purposes. Although not explicitly discussed, the topics addressed herein can be extrapolated for federal generation-skipping transfer tax purposes as well.

A valuation date is the specific date at which the analyst estimates the value of a subject investment interest. The valuation date may be considered one of the most important inputs of the analysis.

For gift tax purposes, the appropriate valuation date is the date of the taxable transfer. For estate tax purposes, the appropriate valuation date is either the date of death or the alternate valuation date (six months after the date of death).

Valuations involving federal tax matters are typically based on the fair market value standard of value. Fair market value is generally interpreted to be based on the consideration of information that was known or knowable as of the valuation date. In other words, the analyst's consideration of subsequent events that were not known or knowable as of the valuation date is generally inconsistent with the fair market value standard of value.

However, there are instances in which subsequent events have been relied on by the U.S. Tax Court ("Tax Court"). Therefore, the analyst should consider analysis-specific facts and circumstances when considering the inclusion of subsequent events to the valuation date in each valuation analysis.

The Tax Court, as well as the valuation professional organizations ("VPOs"), has provided guidance regarding the consideration of subsequent events. Generally, opinions of value only reflect circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date; such an occurrence is typically referred to as a subsequent event.

Subsequent Event Valuation Standards

Valuation analysts sometimes consider subsequent events in valuation analyses. Whether or not such subsequent events are considered in a specific

valuation analysis is based on the facts and circumstances. Those facts and circumstances are influenced by the Internal Revenue Code, the Treasury regulations, and the relevant federal judicial precedent.

Additionally, analysts are required to comply with various professional standards of which they are members. Various VPOs issue professional standards and professional guidance for their members. These standards and guidance influence the analyst's consideration of subsequent events. The following discussion summarizes (1) the applicable tax statutory and judicial guidance and (2) the VPO standards and guidance.

Statutory and Judicial Guidance

Most Tax Court cases that involve subsequent events have concluded that it is inappropriate to rely on subsequent events as direct evidence of value as of the valuation date. That is, if a security is transacted after the valuation date, it is generally not appropriate to simply use that transaction price for a valuation analysis prior to that event occurring.

However, the Tax Court has also found, in some instances, that certain subsequent events that occur within a reasonable time period after the valuation date may be appropriate to consider in the determination of fair market value as of the applicable valuation date.

The Tax Court determines cases that involve U.S. federal tax matters. In these tax matters, valuation issues are typically determined under the standard of value of fair market value.

For U.S. federal gift tax purposes, fair market value is defined in Regulation 25.2512-1, as follows:

> The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property made the subject of a gift, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail . . . . All relevant facts and elements of value as of the time of the gift shall be considered.

Regulation 20.2512 governs that the applicable valuation date is when the gift is made. According to the regulations, the value of property transferred shall be measured as of the date the property is transferred.

For U.S. federal estate tax purposes, fair market value is similarly defined in Regulation 20.2031-1(b), as follows:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail.

Regulation 20.2031 governs that the applicable valuation date is the time of the decedent's death, except if the executor elects the alternate valuation method under Regulation 2032(a).

Regulation 20.2032(a) allows the executor of an estate to elect that the gross estate be valued for estate tax purposes at the alternate valuation date (rather than the date of death) if (and only if) (1) the gross estate has a lower fair market value on that alternate valuation date and (2) the sum of tax imposed with respect to the property includible in the decedent's gross estate is lower under Regulation 20.2032(c).

The alternate valuation date is determined as six calendar months after the date of death. So, for example, if the decedent died on April 15, the alternate valuation date would be October 15.

For valuation purposes, Regulation 20.2032(a) states:

> The value of gross estate may be determined, if the executor so elects, by valuing

all the property included in the gross estate as follows:

> (1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.
>
> (2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.
>
> (3) Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time.

Therefore, generally, for investment interests held through the alternate valuation date for estate tax purposes, events that occurred during the "lapse of time" are includable in the valuation analysis.

Internal Revenue Service Revenue Ruling 59-60 provides guidance regarding the valuation of the stock of closely held corporations and the stock of corporations where market quotations are not available. A revenue ruling is an official interpretation by the Internal Revenue Service (the "Service").

According to Revenue Ruling 59-60, valuations for gift and estate tax purposes should determine fair market value based on the circumstances of each case. The analyst "should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science."

Supportable valuations "will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Further, the "[v]aluation of securities is, in essence, a prophecy as to the future and must be based on facts available at the required date of appraisal." Subsequent events may be confirming evidence to the "prophecy as to the future" in a valuation analysis

The following selected Tax Court determinations provide examples for when subsequent events were both relied on and ignored by the Tax Court. These examples further support the argument for an analyst to consider subsequent events on a case-by-case basis.

Estate of Gilford

In the *Gilford* decision,[1] the Tax Court excluded a subsequent event transaction as the indication of fair market value as of the valuation date.

On November 17, 1979, Saul Gilford died unexpectedly. Mr. Gilford held 381,150 shares (approximately 23 percent) of Gilford Instrument Laboratories, Inc. ("GIL"), stock. Mr. Gilford was also the chairman and chief executive officer of GIL.

The Gilford estate timely filed its estate tax return, electing not to use the alternate valuation date, and reported the value of the GIL stock at $7.35 per share.

GIL stock was actively traded in the over-the-counter market, however, the GIL stock held by Mr. Gilford was restricted under federal securities law. Since Gilford's death occurred on a Saturday, the taxpayer's analyst estimated the value of the GIL stock based on the average of the mean trading price from the preceding Friday and the subsequent Monday.

The taxpayer's analyst arrived at a price of $11.31 per share. However, the value of the stock was discounted by 35 percent in order to account for (1) the size of the block of stock and (2) the restricted nature of the stock.

In a notice of deficiency, the Service determined the fair market value of the GIL stock to be $24.00 per share as of the date of death. This price was based solely on a merger consideration that occurred on May 30, 1980 (195 days after the valuation date). The Service argued that the merger was foreseeable to the estate as of the date of Mr. Gilford's death.

In this case, the Tax Court stated the following:

> In general, property is valued as of the valuation date on the basis of market conditions and facts available on that date WITHOUT REGARD TO HINDSIGHT. However, we have held that postmortem events can be considered by the Court for the "limited purpose" of establishing what the willing buyer and seller's expectations were on the valuation date and whether these expectations were "reasonable and intelligent." *Estate of Jephson v. Commissioner*, 81 T.C. 999 (1983). The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation.

Evidence supported the fact that GIL planned to maintain operations and was not soliciting a sale as of the date of Gilford's death. Additionally, the GIL board of directors did not hire an investment bank to investigate financial alternatives until January 2, 1980.

The Tax Court determined the following:

> On November 17, 1979, there was no reasonable or intelligent expectation that a merger of [GIL] or a sale of petitioner's block of stock between a willing buyer and a willing seller for $24 per share would take place.

Ultimately, the Tax Court concluded that the subsequent event should not be included in determining fair market value as of the date of death and concluded the fair market value of the GIL stock to be $7.58 per share—slightly higher than the taxpayer's original filing. This value determination was based on the historical over-the-counter trading prices and a downward valuation adjustment of 33 percent to account for (1) the size of the block of stock and (2) the restricted nature of the stock.

Based on the *Gilford* decision, transactions which were not reasonably foreseeable as of the valuation date may not be acceptable for providing fair market value indications. It is also important to note that the presence of an active market for the GIL stock further supported the omission of the subsequent event merger price consideration as an indication of value as of the date of death valuation date.

Ringgold Telephone Company v. Commissioner

In the *Ringgold* decision,[2] the Tax Court relied on the value indication of a subsequent event transaction in order to determine fair market value as of the valuation date.

In this case, the Tax Court opined on the fair market value of a 25 percent partnership interest in Cellular Radio of Chattanooga ("CRC") for built-in gain tax purposes. On the valuation date, the Ringgold Telephone Company ("Ringgold") elected to be taxed as a subchapter S corporation for federal income tax purposes.

Prior to the valuation date, Ringgold was taxed as a C corporation. On November 27, 2000, approximately 11 months after the valuation date, the subject interest was sold.

To limit the benefits that can be obtained by converting a C corporation to an S corporation, IRC Section 1374 imposes a corporate level tax on S corporations that formerly were C corporations. At that time, this tax is imposed on any gain (1) that arises before the effective date of the S election (i.e., the built-in gain) and (2) that is recognized by the S corporation within 10 years after the conversion due to a sale or distribution of its assets.

At trial, two valuation analysts presented valuation evidence regarding the fair market value of the 25 percent interest in CRC. One analyst testified for the taxpayer, and one analyst testified for the Service.

The taxpayer's analyst determined the fair market value of the interest in CRC at $2,980,000 as of the valuation date. The Service's analyst determined the fair market value of the interest in CRC at $5,155,000.

During July 2000, approximately six months after the valuation date, the taxpayer and BellSouth entered into an agreement for the sale of the subject interest. The transaction was finalized on November 27, 2000, for $5,220,043.

The Service contended that the fair market value of the subject interest was $5,220,423, based on the transaction price and the Service analyst valuation report.

The Tax Court placed equal weight on (1) the taxpayer's analyst concluded value for CRC based on the capitalization of income method, the discounted cash flow method, the guideline publicly traded company method, and the guideline merged and acquired company method of $2.718 million; (2) the taxpayer's analyst concluded value for CRC based on the capitalization of distributions analysis of $3.243 million; and (3) the BellSouth sale price of $5.220 million.

The Tax Court held that the fair market value of the subject interest was $3,727,141, based on consideration of both (1) the taxpayer's analyst conclusion and (2) the transaction price subsequent to the valuation date.

Before applying emphasis to the BellSouth transaction, the Tax Court considered whether the sale was within a reasonable time after the valuation date.

According to the Tax Court, "the price at which the CRC interest sold was fixed by a formula agreed to 6 months after the valuation date . . . neither party asserts the sale date was not within a reasonable time after the valuation date. We conclude, on the basis of the record, that the sale of the CRC interest to BellSouth occurred within a reasonable time after the valuation date."

Next, the Tax Court considered whether there were any events between the valuation date and the sale date that would have affected the value of the CRC interest.

According to the Tax Court, "Petitioner has not established, and does not argue, that there were intervening circumstances that would have affected value between the valuation date and the sale date . . . . We conclude . . . that there were no intervening events that would have affected value between the valuation date and the sale date."

Based on the *Ringgold* decision, an analyst may consider (1) if a post-valuation date transaction was within a reasonable time frame after the valuation date and (2) if any events occurred between the valuation date and the transaction that would have affected the value of the subject interest.

Valuation Professional Organizations Standards and Guidance

The Appraisal Institute develops and promulgates real estate valuation professional standards. The Appraisal Institute Board of Directors adopted the Appraisal Institute *Standards of Valuation Practice* effective January 1, 2015. These standards are designed so that appraisals (and appraisal reviews) are credible and that appraisal (and appraisal review) reports are credible and not misleading.

The Appraisal Institute issued *Guide Notes to the Standards of Professional Practice of the Appraisal Institute*, noting the following with respect to subsequent events:[3]

> [A]ppraisers are not expected to be prognosticators. Unforeseen events can completely eradicate conclusions that have been based in trend analysis or fundamental market analysis. A market value opinion is as of a particular date, and it is an attempt to reflect the anticipations of market participants as well as market fundamental trends and analysis. Events subsequent to the date of value that were not anticipated by market participants can cause values to change—in some cases, significantly.

The Appraisal Foundation is authorized the U.S. Congress as the source of appraisal standards and appraiser qualifications. The Appraisal Standards Board of the Appraisal Foundation developed the *Uniform Standards of Professional Appraisal Practice* ("USPAP").

USPAP Standards 9 and 10 relate to (1) developing and (2) reporting, respectively, a business or intangible asset valuation. Neither standard references the inclusion or exclusion of subsequent events in a business valuation analysis directly.

However, USPAP Advisory Opinion 34 states the following:[4]

> Data subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date. The appraiser should determine a logical cut-off for the data to be used in the analysis because at some point distant from the effective date, the subsequent data will no longer provide an accurate representation of market conditions as of the effective date. This is a difficult determination to make. Studying the market conditions as of the date of the appraisal assists the appraiser in judging where to make this cut-off. With market evidence that data subsequent to the effective date was consistent with market expectations as of the effective date, the subsequent data should be used. In the absence of such evidence, the effective date should be used as the cut-off date for data considered by the appraiser.

Advisory Opinions are issued to illustrate the applicability of appraisal standards in specific situations and to offer advice from the Appraisal Standards Board for the resolution of appraisal issues and problems, and such opinions are not intended to interpret or establish new standards.

Under USPAP guidance, information (including data) that becomes available after the valuation date may be considered in developing a retrospective value as a confirmation of trends. And, the analyst is instructed to determine a logical cut-off date for

incorporating retrospective information. However, subsequent information should be consistent and confirmatory with market expectations and conditions that existed as of the valuation date. Most VPOs give flexibility to the analyst to make the decision of including or excluding a subsequent event in a valuation.

Unlike USPAP and other valuation standards, the American Institute of Certified Public Accountants ("AICPA") standards with respect to subsequent events are more restrictive, noting that subsequent events are deemed to be not known or knowable as of the valuation date and should, therefore, be excluded from the analysis.

The AICPA publishes standards for its members. The AICPA Statement on Standards for Valuation Services, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* ("VS Section 100") establishes valuation standards that are mandatory for all AICPA members who are engaged to estimate the value of a business, business ownership interest, security, or intangible asset.

Paragraph 43 of VS Section 100 discusses subsequent events, as follows:[5]

> The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimated value. Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date: such an occurrence is referred to as a subsequent event. Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or condition. Moreover, the valuation would typically not include a discussion of those events or conditions because a valuation is performed at a point in time—the valuation date—and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date. In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure in a separate section of the report in order to keep users informed.

Disclosing Subsequent Events in Valuation Reports

Generally, subsequent events do not need to be explicitly discussed in a valuation report for gift and estate tax purposes. That is because analysts have generally accepted that events that occur after a valuation date are not required to be disclosed in a valuation report as of a specific valuation date.

Analysts have accepted that if all of the facts and circumstances that an investor would inquire about up to and as of the valuation date are disclosed in the valuation report, the reasonableness standard of disclosure is met.

In some cases, it may be prudent to disclose subsequent events. These disclosures are often to inform the reader about a subsequent event and how that event may (or may not) affect the conclusion reached as of the valuation date.

Disclosing a subsequent event may be appropriate for providing adequate disclosure in a valuation report for U.S. federal gift and estate tax purposes. The term "adequate disclosure" is defined and its requirements are set forth in Regulation 301.6501(c)-1(f)(3). This regulation section references subsequent events indirectly in that "[i]n order to satisfy the adequate disclosure requirements, the business valuation report must meet the following requirements . . . [t]he appraisal contains . . . [t]he information considered in determining the appraised value…that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value."

USPAP does not require the disclosure of subsequent events in a valuation report. However, if a subsequent event is used as confirmatory evidence to an estimate of value, that subsequent event should be clearly disclosed and discussed how it was used in the valuation analysis.

The AICPA standards permit that if a subsequent event is meaningful to be understood by the reader of the report, then a separate section of the report (e.g., an appendix to the narrative report) should disclose the subsequent event and how that information was not included in the valuation analysis as of a certain valuation date.

This disclosure is also required to be stated for informational purposes only. AICPA VS Section 100 specifically notes that only information known or knowable as of the valuation date should be considered.

Under VS Section 100 paragraph 43, subsequent events are permitted to be disclosed in a valuation report if such disclosure is deemed to be meaningful to the user of the report.

However, subsequent event disclosures that do not bear on the results of the analysis must be included in a separate section of the report and must clearly state that such disclosures are provided for "informational purposes only and do not affect the determination of value as of the specified valuation date."[6]

So, if information was (1) used that occurred subsequent to the valuation date and (2) used to determine fair market value, that information has to be presented and disclosed in such a way that it is clear and understood by the reader.

When evaluating subsequent events, valuation analysts ought to consider what was known or knowable as of the valuation date. The analyst should analyze the market conditions as of the valuation date.

If subsequent events (e.g., data, information, transactions) are supportive of trends that were prevalent as of the valuation date, and such subsequent event is informative to the valuation of the subject interest, then the guidance by the Code, the Tax Court, and USPAP allow for the inclusion of such subsequent event at the direction of the analyst.

VS Section 100 does not permit the inclusion of subsequent events, but it permits the disclosure of subsequent events for informational purposes only.

In situations where this type of information exists and is included or excluded in the analysis, the analyst should document the support and analysis clearly in the narrative report. The analyst should be prepared to support why (or why not) those subsequent events should (or should not) be included (or excluded) as known or knowable as of the valuation date.

Business Valuation Case Examples

The following business valuation case examples illustrate suggestions in how subsequent events may (or may not) be used in a valuation. These examples are presented for illustrative purposes only.

Each valuation analysis is unique and the facts and circumstances will decide whether subsequent event information should (or should not) be included in a valuation.

Example 1: Economic Market Shock

One of the most recognized subsequent events is an economic shock that affects publicly traded marketplaces.

As an example, if the S&P 500 index declines the day after the valuation date, the valuation analyst generally would not include that following day market pricing evidence on the prior day valuation date. That difference—whether higher or lower—generally would not affect the analysis as of the valuation date, and the trading prices (and current market conditions) as of the valuation date would apply.

However, in some situations as noted below (but not limited solely to the below), the analyst may adopt post-transaction-date market shock information in an analysis as of a valuation date.

In certain situations, such as in valuing publicly trading securities and publicly traded bonds for gift tax and estate tax reporting purposes, the valuation may incorporate post-valuation-date trading price information.

For gift tax reporting purposes, under Regulation 25.2512-2(b)(1), if there are no sales of the stock listed and traded on a public market on the date of gift, but there are sales within a reasonable period both before and after the date of the gift, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the date of the gift. The average is to be weighted inversely by the respective number of trading days between the selling dates and the date of the gift—thus, including post valuation date information.

Similarly, under Regulation 25.2512-2(b)(2), if there were no sales of a bond traded on a public exchange within a reasonable period before or as of the date of the gift, the fair market value is determined by taking a weighted average of the quoted closing selling prices on the nearest date before and the nearest date after the date of the gift.

For estate tax purposes, similar rules apply under Regulations 20.2031-2(b)(1) and 20.2031-2(b)(2), respectively. And, for estate tax purposes, economic market shocks may be considered in the valuation of securities if the alternate valuation date applies under Regulation 20.2032(a).

Example 2: Black Swan Events

Generally, black swan events that affect valuation subsequent to the valuation date are not included in a valuation. Black swan events are defined as an unpredictable event that occurs beyond what is normally expected and has a significant consequence.

Black swan events over recent history include the September 11, 2001, terrorist attacks; the Lehman Brothers collapse and the subsequent Great Recession, and the COVID-19 pandemic.

For gift tax purposes, subsequent black swan events are unlikely to be included in a retrospective valuation analysis as of the date of gift transfer.

For estate tax purposes, the estate may elect to value the estate as of the alternate valuation date under Regulation 20.2032(a). If the subsequent black swan event occurred after the valuation date and has a negative value impact on the gross estate value six months after the date of death, the executor can elect to incorporate the effects of the black swan event on the estate assets by electing the alternate valuation date.

For estate tax purposes, under Regulation 20.2032(a), if the assets of the estate are sold during the black swan event impact and the estate makes the alternate valuation date election, the sale proceeds of those transactions would be used for estate tax filing purposes. Thus, the black swan event would be appropriate to include in the alternate valuation date analysis.

Example 3: Subsequent Securities Transaction

In some instances, a subsequent securities transaction may be the best indication of fair market value as of the valuation date. Subsequent securities transactions may be in the form of a merger or acquisition, an initial public offering ("IPO"), or the private sale of a comparable ownership interest. For instance, even if a subsequent transaction occurs after the valuation date of the taxable transfer, there may be an argument for incorporating the sale into the valuation analysis.

For example, in the *Thompson* decision,[7] the Tax Court stated, "if comparable sales occur after the death of decedent, there is no sound reason to ignore them."

The Tax Court has opined that when a subsequent sale is relied on in the estimation of the fair market value, it is necessary to adjust the subsequent sale price for events between the valuation date and the subsequent sale date that affect the subsequent sale price.

For example, in the *Noble* decision,[8] the Tax Court stated the following:

> When a subsequent event is used to set the fair market value of property as of an earlier date . . . adjustments should be made to the sale price to account for happenings between the two dates which would affect the later sale price; these happenings include (1) inflation, (2) changes in the relevant industry and the expectations for that industry, (3) changes in business component results, (4) changes in technology, macroeconomics, or tax law, and (5) the occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or a hypothetical reasonable seller would conclude would affect the selling price of the property subject to valuation (e.g., the death of a key employee).

In the event that there is an IPO after the valuation date, an analyst should at least consider (although, not necessarily rely on) the indicated value of the IPO in the valuation analysis. The Tax Court has rejected expert testimony which has not taken into account the circumstances of future public sales.

For example, in *Silverman*,[9] the Tax Court rejected the expert testimony presented by the taxpayers since the analyst failed to take into account the circumstances of a future public offering, even though the subject stock was in the process of reorganizing with the intent to go public as of the valuation date.

Example 4: Revised Projections/ Forecast/Budget

Financial statement projections are one of the primary inputs in several generally accepted business valuation methods. Financial statement projections directly influence the discounted cash flow method of the income approach and often influence the market approach (either through the use of projected pricing multiples or by adjusting historical pricing multiples based on the subject company's growth expectations).

A recurring dilemma that a valuation analyst faces is whether to consider financial projections, forecasts, or budgets produced after the valuation date. In some instances, financial projections prepared after the valuation date may be the only projections available. Therefore, the analyst may interview company management and conduct the proper due diligence in order to determine if the projections would have a been a reasonable estimate of future income as of the valuation date.

For illustrative purposes, for example, John Smith owns a business which manufactures hotel bedding ("Hbed Inc.") with one major client who accounts for approximately 90 percent of the Hbed Inc. revenue.

On January 1, 2020, Mr. Smith decides to gift a 20 percent interest in Hbed Inc. to a trust. However, one month later, a client which accounted for 90 percent of the Hbed Inc. revenue decides to no longer buy hotel bedding from Hbed Inc. Afterwards,

Hbed Inc. management prepares projections for its lender which include a 90 percent year-over-year decrease in revenue.

The analyst may then consider how to incorporate the projections for the valuation of a 20 percent interest in Hbed Inc. as of January 1, 2020.

In this case, the analyst may avoid relying on the revised projections since they included an unforeseeable event that occurred after the valuation date. However, this event may bring more light to the customer concentration risk that a hypothetical willing buyer and hypothetical willing seller would have considered as of the valuation date.

Therefore, the analyst may incorporate customer concentration risk in the analysis and the subsequent event may support the analyst's decision if challenged in the Tax Court. In this instance, the analyst may consider only relying on historical financial results.

In order to effectively capture the significant customer concentration risk, the analyst may increase the present value discount rate or apply a discount to the company's equity value interests.

Example 5: Loss of a Key Employee

The operations, and underlying value, of a business may be influenced by a key employee. Consequently, the death, disability, or departure of a key employee may detrimentally affect a business's operations.

The presence of a key employee is more common in smaller companies since upper level management is comprised of relatively few employees. In such circumstances, it is possible that the future success of the company is affected by the continued health, success, and contributions of its key leaders and employees.

During due diligence procedures, the analyst may identify key employees and the implications of their sudden departure.

The following six areas may be analyzed to determine whether key person risk is present: (1) management and leadership skill, (2) supplier relationship, (3) customer relationship, (4) innovation skill, (5) debt or equity financing, and (6) employee loyalty.[10]

In the instance that an identified key employee unexpectedly dies, becomes disabled, or departs the subject company after the valuation date, the analyst may still value the company as if the employee were still present.

However, the analyst may incorporate the key person risk in the analysis by adjusting company earnings (historical or projected), adjusting the present value discount rate or capitalization rate, adjusting market based trading pricing multiples, or applying a key person discount at the company level.

Example 6: Legal or Regulatory Event

A single legal or regulatory change may affect the operations or cash flow of a business in a material way. These events can sometimes be anticipated as they are being proposed. However, the analyst is given the difficult task of determining how to incorporate such potential event into the valuation analysis.

In order to incorporate a legal or regulatory event, the analyst should consider what information regarding such event was available as of the valuation date. For example, how should an analyst consider the impact of a tariff which was imposed after the valuation date?

In this case, the analyst may want to ask the following questions: Had the tariff already been proposed as of the valuation date? How likely was the tariff to be implemented after the valuation date? Would a hypothetical willing buyer and hypothetical willing seller consider the operational risk associated with the tariff as of the valuation date?

If the analyst determines that a hypothetical willing seller and buyer would have considered the operational risk associated with the tariff as of the valuation date, then the analyst may decide to incorporate this risk in the valuation analysis.

The analyst may decide to adjust the present value discount rate to account for the additional risk associated with the potential tariff. The analyst may also consider a scenario analysis in which income is projected based on each prospective outcome.

For example, Scenario A projects that the tariff is never imposed and Scenario B projects that the tariff is imposed one month after the valuation date. The analyst could then apply probability weightings to each scenario based on the information that was available as of the valuation date. However, the analyst must be careful to not apply additional weight to a certain scenario based on knowledge that was available after the valuation date.

Example 7: Change in Tax Law

A subject company's tax status and the normalized or effective tax rate of the subject company directly affect the company's cash flow and the cash flow to its stakeholders. Since the expected future cash flow of a company and its cash flow to its stakeholders is a significant input in most business valuations, existing and proposed tax laws often have valuation implications.

> “[T]he effects of subsequent events may be considered in a valuation for gift or estate tax purposes under certain circumstances. . . .”

The most recent major tax law legislation was the Tax Cuts and Jobs Act (“TCJA”), which was signed into law on December 22, 2017. This was the first major change to the Code since the Tax Reform Act of 1986.

The primary valuation-related tax changes in the TCJA that affect C corporations at the entity level are (1) the permanent reduction in the federal corporate income tax rate from a top marginal rate of 35 percent to a flat rate of 21 percent, (2) a permanent limitation on the deductibility of business interest expense, and (3) temporary accelerated (“bonus”) depreciation.

The TCJA also changed the taxation of certain individuals. Individual taxation may be considered when valuing pass-through entities (“PTEs”). This is because owners of PTEs are taxed at individual tax rates based on their pro-rata share of the earnings of the PTE.

The primary valuation-related tax changes of the TCJA that affect individuals are (1) the temporary implementation of a new graduated individual income tax structure; (2) a temporary limit (in aggregate) for certain itemized deductions, including state and local taxes; and (3) a temporary 20 percent deduction of the qualified business income of PTEs.

The valuation consequences of the TCJA may be considered for any analysis with a valuation date after December 22, 2017. However, the analyst may carefully consider if it is appropriate to apply TCJA tax changes to an analysis with a valuation date prior to December 22, 2017.

In general, an analyst may elect to ignore TCJA tax changes for an analysis with a valuation date prior to November of 2017.

However, by November of 2017, there was a reasonable expectation that the TCJA would be signed into law, after its initial release by the House of Representatives on November 2, 2017. Therefore, an analyst may elect to consider certain TCJA tax changes in an analysis with a valuation date from November 2, 2017, to December 22, 2017, however, the analyst should also consider the potential risk of the TCJA not being signed into law during this period.

Summary and Conclusion

This discussion summarized the analyst considerations with respect to subsequent events for federal gift and estate tax purposes.

Taxpayers and analysts should understand the statutory authority, administrative rulings, and judicial precedent, as well as the VPO standards and guidance—with respect to the consideration of subsequent events for valuation purposes.

Generally, opinions of value only reflect circumstances existing at the valuation date and events occurring up to the valuation date. However, as noted above, the effects of subsequent events may be considered in a valuation for gift or estate tax purposes under certain circumstances—with appropriate considerations of the facts and circumstances that were prevalent as of the valuation date.

Notes:

1. Wurster v. Commissioner (In re Estate of Gilford), 88 T.C. 38 (1987).
2. The Ringgold Telephone Company v. Commissioner, T.C. Memo 2010-103.
3. *Guide Notes to the Standards of Professional Practice of the Appraisal Institute* (Chicago: Appraisal Institute, November 17, 2016, minor revisions in 2020).
4. Advisory Opinion 34 (AO-34), 2020-2021 *Uniform Standards of Professional Appraisal Practice*, Effective January 1, 2020, through December 31, 2021 (Washington: The Appraisal Foundation, 2020), 156.
5. VS Section 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (New York: American Institute of Certified Public Accountants, 2007), paragraph 43.
6. *Forensic & Valuation Services Practice Aid, Business Valuations for Estate and Gift Tax Purposes* (New York: AICPA, 2015).
7. Estate of James U. Thompson v. Commissioner, 89 TC No. 43 (1987), note 7.
8. Estate of Helen M. Noble v. Commissioner, T.C. Memo 2005-2.
9. Silverman v. Commissioner, T.C. Memo. 1974-285, *aff.d*, 538 F.2d 927 (2d Cir. 1976), *cert. denied*, 431 U.S. 938 (1977).
10. Shannon P. Pratt, *Discounts and Premiums*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, Inc.), 260–1.

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